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DEPT FOR EUR/CE, EB/OMA, INR/EC; USDOC FOR SAVICH; TREASURY FOR IRS, ERIC MEYER, JEFF BAKER, LARRY NORTON; USEU FOR HAARSAGER

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TAGS: EFIN ECON PGOV HU
SUBJECT: GOVT BOND MARKET WAITING TO BOUNCE BACK

Classified By: P/E COUNSELOR ERIC V. GAUDIOSI; REASONS 1.4 (B) AND (D)

¶1. (C) Summary. The situation in the Hungarian government securities market improved only slightly in recent weeks following a tumultuous autumn that saw yields of 13-14 percent and massive sell-offs by non-resident investors. The government has sought to stabilize the market by suspending regular bond auctions to reduce supply pressure, cutting government expenditures to lower the country's net financing needs, and relying on EU and IMF loans to eliminate the need to go to international capital markets. Despite these actions, investors have yet to return, and non-resident investors remain net sellers. There is growing concern that excessively high FX exposure in Hungary's debt portfolio or a failure to meet deficit reduction or other commitments made under the terms of its IMF loan could result in further downgrades in Hungary's rating by international credit rating agencies, thus further delaying the recovery of Hungary's financial markets. End summary.

AUTUMN TURMOIL IN THE BOND MARKET

¶2. (SBU) Global deleveraging, investor risk aversion, and a lack of confidence in Hungarian macroeconomic fundamentals created a crisis in the government securities market in October, as the market virtually froze from a lack of demand that pushed yields as high as 13-14 percent. Following a decade of annual increases in non-resident holdings of Hungarian government securities, the sell-off in October and November was particularly dramatic - the volume of foreign-owned Hungarian government securities decreased by approximately USD 4 billion, a decline of over 25 percent. Non-residents hold about 30 percent of Hungary's forint-denominated debt (about 8 percent of treasury bills and 35 percent of treasury bonds). Hungarian Debt Management Agency (AKK) Managing Director Laszlo Buzas also notes that Hungary's downgrade by international credit rating agencies this fall contributed to the sell-off by making Hungarian government securities less attractive to a number of institutional investors.

GOVERNMENT RESPONDS

¶3. (SBU) In response, AKK revised its debt financing plan to reduce supply pressure on the government bond market, suspending remaining 2008 issuances. In mid-December the agency released its 2009 debt financing plan, which calls for a further decrease in the supply of bonds and schedules no regular government bond auctions during the first quarter of ¶2009. In addition, in October the Hungarian National Bank (MNB) began purchasing government bonds with 1-3 year maturity dates, but discontinued doing so in early December as Hungary's financial market environment improved.

¶4. (SBU) The government is also reducing its 2009 financing

needs through deficit reduction. Under the terms of the international stabilization package, Hungary agreed to accelerate its fiscal consolidation and reduce its deficit to 2.6 percent, which should reduce Hungary's net financing needs for 2009 by nearly USD 400 million. Subsequent predictions of a significant economic contraction, however, will increase the pressure on the GoH to revisit these targets.

¶5. (SBU) Moreover, in 2008 Hungary has made use of EUR 1 billion of the IMF and EU stand-by arrangements to redeem expired debts and finance repurchase auctions, thereby reducing the amount of bond issuances required. It expects to use another EUR 5 billion (HUF 1,430 billion) in 2009.

BUT INCREASES FOREIGN CURRENCY EXPOSURE IN THE PROCESS

¶6. (SBU) This use of the IMF and EU credit lines will increase AKK's foreign currency exposure. The agency's current debt management guidelines call for a maximum HUF-FX debt ratio of 32 percent. AKK expects to use approximately EUR 5 billion from the credit line in 2009, which would increase the FX ratio in Hungary's debt portfolio to over 35 percent. AKK CEO Laszlo Szarvas cautions that this would create a risk of possible downgrades of Hungary's sovereign debt rating, but expressed the hope that the credit rating agencies would understand the extraordinary situation.

¶7. (C) In addition, AKK's Buzas tells us that they are in discussions with the MNB about the possibility of swapping euros for forints, which would reduce AKK's foreign currency exposure and could enable the MNB to put additional medium

term foreign exchange in the market. Buzas notes, however, that discussions are ongoing and the MNB has not yet agreed to such an arrangement.

SLIGHT THAW, BUT WHEN COMES THE MELT?

¶8. (U) The situation improved somewhat in December, as yields declined to 8-9.5 percent. AKK Senior Managing Director Laszlo Borbely points to increased domestic demand and higher demand at auctions as a sign that markets are beginning to normalize. Analysts caution, however, that this may not be the case, noting that non-resident investors remain net sellers, and that AKK is keeping supply artificially low to help stabilize the market.

¶9. (C) Considerable uncertainty remains regarding when foreign investors will return to Hungary's financial markets. AKK's Buzas believes that foreign investor deleveraging has not come to an end, estimating that there may be as much as HUF 800 - 1 trillion (USD 4-5 billion) yet to come. Some are concerned that if demand for government securities does not pick up in 2009 - or if the Hungarian economy faces some new crisis - AKK will be forced to once again revise its debt financing plan and the GoH may look to use more of the IMF and EU credit lines for government financing.

¶10. (SBU) When asked when they plan to resume regular auctions, AKK officials express the hope to resume regular auctions during the second quarter of 2009, but tell us they are trying to remain flexible, and have been in discussions with market participants.

THE RISK OF A DOWNGRADE

¶11. (C) Comment. There is a risk that excessively high FX exposure in Hungary's debt portfolio, or a failure to meet deficit reduction or other commitments made under the terms of its IMF loan could result in further downgrades in Hungary's rating. All three major international credit rating agencies have already issued a negative outlook following November and December downgrades. S&P, for example, noted that Hungary's ratings could be lowered

further "if political support for fiscal consolidation were to falter." Further downgrades by credit rating agencies could delay investors' return to Hungary, or even cause many remaining investors to close their positions here in search of lower-risk investments. This would exacerbate Hungary's problems in restoring investor confidence, and possibly delay the return of normally functioning markets. End comment.

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